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LATHAM & WATKINS

ATTORNEYS AT LAW
1001 PENNSYLVANIA AVE., N.W.
SUITE 1300
WASHINGTON, D.C. 20004-2505
TELEPHONE (202) 637-2200
FAX (202) 637-2201

PAUL R. WATKINS (1899-1973)
DANA LATHAM (1898-1974)

CHICAGO OFFICE
SEARS TOWER, SUITE 5800
CHICAGO, ILLINOIS 60606
TELEPHONE (312) 876-7700
FAX (312) 993-9767

LONDON OFFICE
ONE ANGEL COURT
LONDON EC2R 7HJ ENGLAND
TELEPHONE + 44-171-374 4444
FAX + 44-171-374 4460

LOS ANGELES OFFICE
633 WEST FIFTH STREET, SUITE 4000
LOS ANGELES, CALIFORNIA 90071-2007
TELEPHONE (213) 485-1234
FAX (213) 891-8763

MOSCOW OFFICE
113/1 LENINSKY PROSPECT, SUITE C200
MOSCOW, RUSSIA 117198
TELEPHONE + 7-503 956-5555
FAX + 7-503 956-5556

NEW JERSEY OFFICE
ONE NEWARK CENTER
NEWARK, NEW JERSEY 07101-3174
TELEPHONE (201) 639-1234
FAX (201) 639-7298

NEW YORK OFFICE
885 THIRD AVENUE, SUITE 1000
NEW YORK, NEW YORK 10022-4802
TELEPHONE (212) 906-1200
FAX (212) 751-4864

ORANGE COUNTY OFFICE
650 TOWN CENTER DRIVE, SUITE 2000
COSTA MESA, CALIFORNIA 92626-1925
TELEPHONE (714) 540-1235
FAX (714) 755-8290

SAN DIEGO OFFICE
701 "B" STREET, SUITE 2100
SAN DIEGO, CALIFORNIA 92101-8197
TELEPHONE (619) 236-1234
FAX (619) 696-7419

SAN FRANCISCO OFFICE
505 MONTGOMERY STREET, SUITE 1900
SAN FRANCISCO, CALIFORNIA 94111-2562
TELEPHONE (415) 391-0600
FAX (415) 395-8095

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February 20, 1997

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FEB 20 1997

Federal Communications Commission
Office of Secretary

William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: In the Matter of Federal-State Joint Board on Universal Service
CC Docket No. 96-45
Ex Parte Presentation

Dear Mr. Caton:

On February 19, 1997, Donn T. Wonnell of Pacific Telecom, Inc. ("PTI") and Nicholas W. Allard and Teresa D. Baer of Latham & Watkins met with the individuals listed below regarding universal service issues.

Charles Bolle	South Dakota Public Utilities Commission
Bryan Clopton	Federal Communications Commission
Emily Hoffnar	Federal Communications Commission
David Krech	Federal Communications Commission
Sandra Makeeff	Iowa Utilities Board
Tejal Mehta	Federal Communications Commission
Barry Payne	Indiana Office of the Consumer Counsel
Paul Pederson	Missouri Public Service Commission
Brian Roberts	California Public Utilities Commission
Tom Wilson	Washington Utilities and Transportation Commission

Copies of PTI's February 18, 1997 comments filed in this proceeding were distributed at the meeting. A copy of those comments is enclosed.

Due to the fact that the meeting was held late in the afternoon on February 19, this letter is being filed today.

An original and two copies of this letter are enclosed.

Very truly yours,

Teresa D. Baer

Teresa D. Baer

Enclosures
cc (w/out enclosures):
Charles Bolle
Bryan Clopton
Emily Hoffnar
David Krech
Sandra Makeeff
Tejal Mehta
Barry Payne
Paul Pederson
Brian Roberts
Tom Wilson
Donn T. Wonnell

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEB 1 8 1997

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of Staff Analysis on Analysis of Forward-Looking Economic Cost Proxy Models	)	CPD Docket No. 97-2

COMMENTS OF PACIFIC TELECOM, INC. ON THE
STAFF ANALYSIS OF FORWARD-LOOKING ECONOMIC COST PROXY MODELS

Pacific Telecom, Inc. ("PTI") submits these Comments in response to the Commission's January 9, 1997 Public Notice relating to the Commission Staff Analysis of the potential use of cost models for determining universal service support payments, cost-based access charges, and interconnection and unbundled network element pricing. In its previous comments on universal service issues, PTI has shown that the needs and requirements of rural carriers are "unique," and has further noted that both the Commission and the Federal-State Joint Board on Universal Service ("Joint Board") have acknowledged this fact at various points in the universal service, interconnection, and access charge proceedings.[1] There is a growing consensus that rural carrier issues require formal, separate study.[2] The Staff Analysis under

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1 See Comments of Pacific Telecom, Inc. Relating to Staff Workshops on Proxy Cost Models, CC Docket No. 96-45 (filed January 24, 1997) ("PTI Workshop Comments"); Comments of Pacific Telecom, Inc. in Response to Questions Relating to Proxy Cost Models (filed Jan. 7, 1997), in Federal-State Joint Board on Universal Service, CC Docket No. 96-45 ("PTI Question Response").

2 PTI is informed that the United States Telephone Association, in comments filed contemporaneously with PTI's Comments in this proceeding, will argue that:

discussion here reinforces the need for timely action to create a vehicle for studying rural cost and modeling issues, prior to the implementation of any cost model -- for universal service or any other purpose -- for rural telephone companies.

As an operator of rural telephone companies throughout the Midwest, Pacific Northwest, and Alaska, PTI is concerned especially about how the three Commission proceedings that make up the "Competition Trilogy" -- Universal Service, Local Competition, and Access Charge Reform -- as well as other related proceedings, apply to rural carriers, particularly with respect to their ability to recover basic network investment while maintaining reasonable customer rates. PTI previously urged the Commission to appoint a separate rural panel to work with the federal and state commission staffs as part of the recent cost model workshops held on January 14-15, 1997. The workshops have passed, but the need to address rural issues remains. The conclusions in the Staff Analysis addressing the interrelationship of the Commission's several proceeding reinforces this need. Clearly, the time is ripe for the Commission to take an affirmative step toward addressing a matter that the Joint Board and many parties now agree requires comprehensive review and consideration.

> As the Joint Board itself recognized, there must be an opportunity to "tailor the model for rural companies" in order to "take into consideration the unique situation of rural carriers." USTA recommends that the Commission establish a task force under Joint Board auspices to evaluate the appropriateness of the model for rural carriers and to make recommendations concerning whether the model chosen for non-rural companies (or any other model) can be utilized for rural companies. The efforts of the task force could be completed during the three-year transition period recommended by the Joint Board. Comments of USTA at 7 (filed February 18, 1997).

PTI subscribes to this approach and endorses USTA's request herein.

There can be no serious dispute about rural telephone companies' special needs or the importance of minimizing any adverse impact on their ability to recover their costs and maintain service through appropriately tailored mechanisms. In its Recommended Decision, the Joint Board emphasized the unique characteristics of rural carriers in recommending that rural carriers not be subject to a proxy cost model immediately. The Joint Board specifically acknowledged that "[s]ince rural carriers generally serve fewer subscribers relative to the large incumbent LECs, serve more sparsely populated areas, and do not generally benefit from economies of scale and scope as much as non-rural carriers, they often cannot respond to changing operating circumstances as quickly as large carriers."[3] As Exhibit A demonstrates, the Joint Board's Recommended Decision is replete with references to the fact that small and rural carriers are unique and, therefore, warrant a separate focus.

PTI noted in its Workshop Comments that the discussion during the Commission's universal service workshops contained little, if any, substantive, comprehensive analysis of how the models would perform in the context of rural serving requirements.[4] To the extent that rural concerns were addressed at all, most speakers declined to offer any detailed analysis of rural issues and effects, generally on the ground that rural cost modeling issues, having been deferred by the Joint Board, were not a timely object of discussion. PTI attaches as Exhibit B a chart citing the comments made during the recent workshops to the fact that rural areas are unique and require additional study before the Commission adopts any cost model on which to base universal service support payments to rural LECs.

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3 Federal-State Joint Board on Universal Service, Recommended Decision, FCC 96J-3, CC Docket No. 96-45, at ¶ 283 (released Nov. 8, 1996) ("Recommended Decision").

4 PTI Workshop Comments at 3.

Moreover, the Staff Analysis in particular raises the issue of whether a forward-looking cost model can be used to determine universal service support payments, cost-based access charges and interconnection and unbundled network element pricing. The Commission has recognized that this set of interrelated proceedings will have a significant and substantial impact on the manner in which rural and small LECs recover their investment. The Commission explained this interrelationship in the Local Competition First Report and Order:[5]

> It is widely recognized that, because a competitive market drives prices to cost, a system of charges which includes non-cost based components is inherently unstable and unsustainable. It is also well-recognized that access charge reform is intensely interrelated with the local competition rules of section 251 and the reform of universal service. We will complete access reform before or concurrently with a final order on universal service.
>
> Only when all parts of the trilogy are complete will the task of adjusting the regulatory framework to fully competitive markets be finished. . . . We will, however, act quickly to complete the three essential rulemakings. We intend to issue a notice of proposed rulemaking in 1996 and to complete the access charge reform proceeding concurrently with the statutory deadline established for the section 254 rulemaking. This timetable will ensure that actions taken by the Joint Board in November and this Commission by not later than May 1997 in the universal service reform proceeding will be coordinated with the access reform docket.[6]

In the Access Charge Reform Notice, the Commission again stressed that, "because of the role that access charges have played in funding and maintaining universal service, it is critical to implement changes in the access charge system together with

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5 Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, CC Docket No. 96-98, FCC 96-325 (released Aug. 9, 1996) ("Local Competition First Report and Order").

6 Id. at ¶¶ 8-9.

complementary changes in the universal service system."[7] In Exhibits C and D, PTI has catalogued the references in both the Local Competition First Report and Order and the Access Charge Reform Notice in which the Commission has indicated that rural issues are unique. These exhibits underscore the need for a rural task force to examine further the correlation, if any, among these three proceedings and the use of cost models for rural carriers.

The Joint Board already "recommend[ed] that the Commission, working with the state commissions, review the proxy model to ensure that it takes into consideration the unique situations of rural carriers."[8] PTI concurs and urges the Commission to establish a rural task force, under continuing Joint Board oversight,[9] as part of its final disposition of universal service matters on or before May 8, 1997.[10] Specifically, the Commission, either in its final disposition of universal service matters by May 8, 1997 or in a separate order before that date, should appoint a task force representing rural telephone companies so that the business of analyzing the regulatory environment in which such rural companies operate can begin promptly. Addressing forward-looking cost issues for rural telephone companies in this manner will not interfere with any existing schedule in any of the Commission's proceedings implicating such cost

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7 Access Charge Reform, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket Nos. 96-262, 94-1, 91-213, 96-263, at ¶ 244 (released Dec. 24, 1996) ("Access Charge Reform Notice").

8 Recommended Decision at ¶ 283.

9 The task force could report directly to the Joint Board. As such it would not be subject to the requirements of the Federal Advisory Committee Act, 5 U.S.C. App. 2 (1988).

10 See 47 U.S.C. § 254(a)(2).

development.[11] Conversely, doing so will promote the efficient, fair, and comprehensive resolution of issues unique to rural carriers.

For the foregoing reasons, as well as the reasons stated in PTI's January 7, 1997 Questions Response and in its January 24, 1997 Workshop Comments, PTI respectfully requests that the Commission promptly appoint a task force comprised of rural company representatives to address rural carrier needs in the context of analyzing cost models for potential use in universal service funding and other related Commission proceedings.

Respectfully submitted,

PACIFIC TELECOM, INC.

By: Michael S. Wroblewski

Gary M. Epstein
Teresa D. Baer
Michael S. Wroblewski
LATHAM & WATKINS
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 637-2200

Donn T. Wonnell
Vice President, Regulatory Affairs
PACIFIC TELECOM, INC.
805 Broadway
Vancouver, Washington 98660
(360) 905-7372

February 18, 1997

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11 The Commission already has noted that rural telephone companies are exempt from interconnection requirements under the provisions of 47 U.S.C. § 251(f)(1). See Local Competition First Report and Order at ¶¶ 1262-1265. As discussed above, the Joint Board has proposed a separate period for development and application of cost model principles to rural telephone companies. See Recommended Decision at ¶ 283. The Access Charge Reform Notice applies only to price cap companies, which in effect generally excludes rural telephone companies. See Access Charge Reform Notice at ¶ 52 & n.88.

CERTIFICATE OF SERVICE

I hereby certify that I have this 18th day of February, 1997, caused a copy of the foregoing "Comments of Pacific Telecom, Inc. on the Staff Analysis of Forward-Looking Economic Cost Proxy Models" to be served by first class mail, postage prepaid, and by hand on the following:

The Honorable Reed E. Hundt, Chairman
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

The Honorable Rachelle B. Chong, Commissioner
Federal Communications Commission
1919 M Street, N.W., Room 844
Washington, D.C. 20554

The Honorable Julia Johnson, Commissioner
Florida Public Service Commission
Gerald Gunter Building
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

The Honorable Kenneth McClure, Commissioner
Missouri Public Service Commission
301 W. High Street, Suite 530
Jefferson City, Missouri 65101

The Honorable Sharon L. Nelson, Chairman
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia, Washington 98504-7250

The Honorable Laska Schoenfelder, Commissioner
South Dakota Public Utilities Commission
State Capitol, 500 E. Capitol Street
Pierre, South Dakota 57501-5070

Martha S. Hogerty
Public Counsel for the State of Missouri
P.O. Box 7800
Jefferson City, Missouri 65102

Paul E. Pederson, State Staff Chair
Missouri Public Service Commission
P.O. Box 360
Jefferson City, Missouri 65102

Tom Boasberg
Federal Communications Commission
Office of the Chairman
1919 M Street, N.W., Room 814
Washington, D.C. 20554

Charles Bolle
South Dakota Public Utilities Commission
State Capitol, 500 E. Capitol Street
Pierre, South Dakota 57501-5070

Deonne Bruning
Nebraska Public Service Commission
300 The Atrium, 1200 N Street
P.O. Box 94927
Lincoln, Nebraska 68509-4927

James Casserly
Federal Communications Commission
Commissioner Ness' Office
1919 M Street, N.W., Room 832
Washington, D.C. 20554

Rowland Curry
Texas Public Utility Commission
1701 North Congress Avenue
P.O. Box 13326
Austin, Texas 78701

Bruce B. Ellsworth
New Hampshire Public Utilities Commission
8 Old Suncook Road, Building No. 1
Concord, New Hampshire 03301-5185

Daniel Gonzalez
Federal Communications Commission
Commissioner Chong's Office
1919 M Street, N.W., Room 844
Washington, D.C. 20554

Emily Hoffnar, Federal Staff Chair
Federal Communications Commission
2100 M Street, N.W., Room 8623
Washington, D.C. 20554

Lori Kenyon
Alaska Public Utilities Commission
1016 West Sixth Avenue, Suite 400
Anchorage, Alaska 99501

Debra M. Kriete
Pennsylvania Public Utilities Commission
P.O. Box 3265
Harrisburg, Pennsylvania 17105-3265

Mark Long
Florida Public Service Commission
Gerald Gunter Building
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399

Sandra Makeeff
Iowa Utilities Board
Lucas State Office Building
Des Moines, Iowa 50319

Philip F. McClelland
Pennsylvania Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, Pennsylvania 17120

Michael A. McRae
D.C. Office of the People's Counsel
1133 15th Street, N.W., Suite 500
Washington, D.C. 20005

Terry Monroe
New York Public Service Commission
3 Empire Plaza
Albany, New York 12223

Lee Palagyi
Washington Utilities and Transportation Commission
1300 South Evergreen Park Drive S.W.
Olympia, Washington 98504

Barry Payne
Indiana Office of the Consumer Counsel
100 North Senate Avenue, Room N501
Indianapolis, Indiana 46204-2208

James B. Ramsay
National Association of Regulatory Utility Commissioners
P.O. Box 684
Washington, D.C. 20044-0684

Brian Roberts
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, California 94102

Andrea Rainey

Andrea Rainey

A

6	• Recommending, in the case of areas served by rural telephone companies, that such companies' existing study area be used as the designated service area.
7	• Recommending a system for determining the level of universal service support for telecommunications carriers. • Stating that support for rural telephone companies will initially be based on embedded costs, which is a different method from how support is calculated for other telephone companies. • Stating that rural telephone companies will be permitted to calculate support levels using embedded costs for three years after large companies begin to use proxy cost models.
65	• Noting that customers who live in rural areas especially require access to interexchange service to reach medical and emergency services, schools and local government.
69	• Declining to recommend additional services be included in the general definition of universal service. • Specifically declining to support total access to internet providers based on the prediction that increasing demand for internet service will result in broader accessibility of internet service providers, thus having the effect of reducing or eliminating the need for customers in rural areas to place toll calls to obtain internet service.
91	• Finding that designated services carrying single connection businesses in a rural, insular and other high cost areas should be supported by universal mechanisms although at reduced levels of support. • Reasoning that for small single connection businesses and high cost areas, the price of telephone service may be prohibitive without support.

92	Concluding that designated services carried to businesses subscribing to only one connection should not receive the full amount of support designated for residential connections and high cost areas.
172	• Recommending that the FCC retain the current study areas of rural telephone companies as the service areas for such companies. • Finding no persuasive rationale in the record for adopting a service area that differs from a rural telephone company's present study area.
173	• Noting that the 1996 Act in many respects places rural telephone companies on a different competitive footing from other local exchange companies.
184	• Recognizing that the use of a proxy model could cause some small carriers to receive levels of support different from what they currently receive. • In order to allow carriers a reasonable period to adjust to the use of proxy models, recommending that rural telephone companies be allowed to continue using embedded costs as the basis for calculating the universal service support levels for three years after non-rural carriers begin to use proxy models. • Recommending that during that period, high cost assistance, DEM waiting and LTS benefits for rural carriers be frozen based on historical per line amounts. • Recommending at the end of that three-year period, rural companies will transition to a proxy model over three years. Because of the nature of providing service in Alaska and the insular areas, recommending that rural carriers serving those areas continue to use embedded costs until further review.
271	• Recognizing that the operations of some carriers could be placed at risk if their support was immediately determined by the use of a proxy model. • Finding that the proposed proxy models designed do not reflect the special characteristics of such carriers for: (1) none of the models adequately represents the cost for rural carriers as all the models are

[redacted]	
	currently based on expense data for large LECs serving predominately urban areas; (2) small carriers with their limited revenue streams will be significantly affected if the model does not accurately reflect their costs; and (3) the proxy model should be refined and modified to reflect the special characteristics of rural carriers before requiring those carriers to move to a proxy model for determining universal service support.
272	• Recommending that a proxy model needs to be tailored for rural companies. • Recommending that the commission include a review of the proxy model to ensure the appropriateness of the proxy model for rural carriers before requiring them to use a proxy model. • Recognizing that the use of historical per-line amount will minimize any disruption or adverse impact of this change on the rural carriers.
283	• Recognizing that there is a concern about moving small, rural carriers to a proxy model too quickly because such a move may result in large changes in the support that they receive. • Noting that since rural carriers generally serve fewer subscribers relative to the large incumbent LECs, serve sparsely populated areas, and do not generally benefit from economies of scale and scope as much as non-rural carriers, they often cannot respond to changing operating circumstances as quickly as large carriers. • Recommending that those carriers not move immediately to a proxy model, but transition to a proxy over six years.
284	• Concluding that a properly designated cost proxy model would allow carriers serving high cost areas to charge affordable rates.
285	• Finding that because of the difficulty in precisely calculating small, rural carrier's costs, these carriers should continue to draw high cost support calculated based on an embedded cost methodology until there is more experience with the proxy models.
286	• Recommending that rural carriers be able to move to a proxy based system earlier if they choose to do so. • Recognizing that rural carriers will choose to move earlier only when the proxy cost is greater than the embedded cost.

	• Recognizing that providing the rural carriers this opportunity is necessary to ensure that rural carriers have an incentive to invest in the facilities required to provide the supported services. • Recognizing the alternative, limiting rural carriers to embedded costs when forward looking economic costs are greater than embedded costs, would encourage rural carriers to withdraw service in high cost areas or require rural carriers to incur an economic loss in the provision of the supported services.
289, 290 291	• Setting up a structure for gradually shifting to a proxy based methodology. Discussing that the benefits of freezing support are that rural carriers are encouraged to operate efficiently because no additional support will be provided for increased cost. • Recommending that the total amount paid to each carrier based on 1997 embedded cost be divided by the number of loops served at the end of 1995. • Recommending that support not be frozen at a total dollar amount but instead at a per-line amount. • Rural carriers would receive additional support at the same amount per line as the number of subscribers increase. • A frozen level of high cost support will prepare these LECs for their move to a proxy model in the advent of a more competitive market place.
295	• Recognizing there is a limited participation in the frozen LTS mechanism to rural telephone companies. • Finding that this limitation is proper because LECs not qualifying as rural telephone companies should receive high cost universal service support based on a proxy model per cost including loop costs.
296	• Finding that since rural ILECs have the option at any time to convert their support basis to a proxy methodology, a CLEC should also have the opportunity to choose proxy based support when it enters a rural ILEC study area.

297	• Concluding that using the rural ILEC embedded costs to calculate universal service support for all eligible telecommunications carriers serving customers within that rural ILEC's study area will be the easiest way to administer the support mechanism.
313	• Stating that using the nationwide average revenue as a benchmark would encourage carriers to market and introduce new services in high cost areas. • This decision will provide carriers the incentive to upgrade their service offerings in high cost areas, and therefore, maintain high quality service in rural areas that is comparable to the service offered in urban areas.
434	• Recognizing the special circumstances faced by carriers and consumers in the insular areas of the United States. • Noting at the outset that carriers in these areas, like all other carriers, will be eligible for universal service support if they serve high cost areas. • Recommending that rural carriers serving high cost insular areas, as well as rural carriers serving high cost areas in Alaska, should continue to receive universal service support based on their embedded costs.

B

PROXY COST MODELS WORKSHOPS
Comments of Panelists (January 14 and 15, 1997)

Panel 1: Modeling Network Investment

- The uniform distribution of households, which is a factor that affects the distribution network design, can result in an overstatement of costs in very rural areas.
- Commenting that the second version of the Benchmark Costing Model ("BCM") made a big improvement for rural areas because customers were moved from being uniformly distributed over census block groups ("CBGs") to being uniformly distributed over roads.
- Recommending that sample data, which tells what the typical length of loops in rural areas are, should be collected because that type of information would be the ideal source of data for determining the uniform distribution of households.
- Stating that with regard to the small company environment, use of the Hatfield model may not be appropriate because the model does not account for a whole different set of assumptions.
- Another panelist countered the above comment, stating that the model works "perfectly fine" for rural companies when the data is available and it is a database issue.
- Stating that with regard to the CBG, the variance for the small company data was "so far off". Noting that it is difficult to tell exactly where the variance is coming from, i.e., is the variance strictly material or is it a design issue.
- Noting that for small telephone companies, the mechanics do not work the same as for larger companies and that could affect the way assignments for customers are allocated.
- Stating that Ben Johnson's model ends up giving lower unit costs for installing cable in central business districts than it would in rural areas because of the way clinching and conduit is handled when there are a large number of customers.
- Recognizing that sharing is done differently in urban areas, suburban areas and rural areas and stating that the BCM recognized the differences in sharing so that sharing can occur by element.

Panel 2: Modeling Operating and Support Expenses

- Noting that there may be a number of small companies that were not in existence in 1995, do not have frozen numbers and will need to use the models immediately, as opposed to waiting during the transition.
- Stating that the model adopted in May needs to include the ability to analyze and deal with small companies as well as large ones.
- Recognizing that small company expenses are different from large company expenses both in the plant specific categories and in customer operations.
- Comparing nationally available data of large companies and small companies, in general, and noting that the small company plant specific costs both on a per line basis and in relation to telephone plant and service are slightly less.
- Stating that customer and corporate operation expenses are substantially greater than they are in the larger companies.
- Suggesting that BCM models should at least recognize some of these differences as company size varies.
- Stating that dealing with the expenses for small companies may have been a perceived deficiency in the Hatfield model since its release back in August which contained information only for the RBOCs. Since that period information has been provided on a state-by-state basis primarily for tier one companies.
- Techniques have been developed since the initial filing of the model in each state study area.
- Stating that although the RBOCs and some of the larger independents have a more urban experience and more urban network, there should not be that much variance in the cost experience by one of the tier one companies and one of the smaller independents. The release of the new version of the Hatfield model will include information that will permit the model to be run for all companies.
- Suggesting that the FCC could at least ask a sample of small companies to provide appropriate detailed data. Also stating that better data gathered from the big companies could also be accomplished.
- Stating the BCM recognizes the differences between small, medium and large companies.
- Recognizing that the expense dollars and investment dollars are currently only known for the large companies.
- Although, currently, data from the small companies has not been provided to include in the model, currently available information on small companies includes REA/RUS data and there is the assumption that NECA data could be provided in a data request to help create small company values that could be inputted into the model.
- Recognizing that what is trying to be accomplished by having separate input for large, medium and small companies is to recognize the economies and scales of scope of each.
- Recognizing the need to understand the overlap between small TELCOS and rural carriers, which are exempted for three years from the cost proxy model. Stating that there needs to be a starting point for small TELCOS and, for lack of another starting point, it should start with tier one companies and after that, should look to small TELCOS to step forward and identify where and how their expenses differ from ILECs.

- Recognizing that it might be helpful to consider what is causing the difference in expenses, i.e., is it the size of an ILEC that allows it to command a much higher switch discount or is it a regional difference or is it a high cost area.
- Recognizing that in looking at a cost proxy model it is important to understand what is causing the difference in the expenses base by a small TELCO versus a large TELCO.

Panel 3: Modeling Capital Expenses

- Recognizing that the models should provide incentives which will decide whether there is a good network in rural areas or if there is not a good network in rural areas.
- Stating that if payment for the universal service is less than the forward looking costs of providing universal service, competitors will not invest in the network in the rural areas.
- Stating that for these opportunities and technologies to occur, the models should not include costs that are less than what the actual costs of building such a network is.
- Noting that there is already a network investment that is less than the actual costs because it has to be a continuing efficient technology. Stating that if the costs of capital are included that is also less and depreciation rates are less, there will not be investment in the telecommunications network in rural areas.
- Responding to above comment and stating that the purpose of the Telecommunications Act of 1996 and of the universal support mechanism is to encourage competitors to enter the rural market through their eligibility to receive universal service support payments which they cannot receive today.

Panel 4: Validation of Models

- Questioning whether the models, in relation to smaller companies, perform well. Stating that there are concerns raised about the relationship to the embedded costs.
- Questioning what occurs after the transition period when it appears that the models may not be working as they have in the previous three years for the larger companies.
- Responding to above question, stating that the deficiencies in the models, particularly in both the BCM II and its successor, as well as Hatfield and its successor, are so extreme that they are not only misallocating dollars between little companies, but they are misallocating debt dollars between pier one companies.
- Stating that an inherent defect of those models is creating such substantial errors that for big companies, they may be able to live with it. Stating that, conversely, little companies are going to die. You have to correct the fundamental modeling errors, which are the distributional customers, as well as the CBG problem.
- Elaborating that the assumptions in some of the models were wrong and that if you use incorrect assumptions and try and model the distribution of dollars based on those assumptions, little companies are going to die.

C